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The Mounting Costs of Internal Investigations

By Peter J. Henning March 5, 2012 11:07 am



Arthur Edwards/News international, via Associated PressRupert Murdoch, right, at The Sun in London last month. News Corporation began an internal inquiry of telephone hacking and corrupt payments to British officials last year.

Lawyers, as everyone knows, can cost a lot of money.

When a corporation is caught in a government investigation, the legal fees can quickly exceed \$100 million – and that's before the lawsuits even begin. Once the government files charges, those costs can continue to grow as companies are required to pay the legal fees for any officers or directors accused of wrongdoing.

Is there any way to limit these costs? The short answer is probably not, but a bill introduced in Congress last year might signal a way for companies to give themselves a mechanism to recover some the payments if a former

officer or director is found to have violated the law.

When a criminal or civil regulatory investigation begins, a company's typical first response is to commission an internal investigation to gather information about potential wrongdoing. Companies routinely vow to share the results of the investigation with the authorities to keep the government from rooting around for evidence.

Investigations are usually overseen by outside lawyers acting on behalf of the company's audit committee or other special committee, relying on the attorney-client privilege as a shield to keep the results of the inquiry confidential until the company is ready to disclose any findings.

How much can an internal investigation cost? It depends on the issue, but the lawyers will have free rein to pursue any lead about potential misconduct because a company wants to be able to tell the government it left no stone unturned. So cost is rarely an issue while the investigation is pursued.

Some recent examples show how much these investigations can cost. In its annual report filed last week, Avon Products disclosed that it spent about \$93.3 million in 2011 on an internal investigation of possible violations of the Foreign Corrupt Practices Act, on top of \$95 million spent in 2010 and \$59 million in 2009. The case still has not been resolved, and the fact that there was only a minuscule decline in the legal costs last year indicates that the investigation has uncovered a wider range of possible violations.

News Corporation began an internal investigation of telephone hacking and corrupt payments to British officials last year, and in the last six months of 2011 it spent \$104 million to pay for its lawyers along with settlements in private suits. There are reports that the F.B.I. is looking into potential bribes paid by a Russian billboard subsidiary of the company, so those costs are

likely to grow over the next year.

Neither company has incurred a bill for an internal investigation like Siemens A.G., which reported incurring costs of more than \$1 billion for a global inquiry into payment of bribes to foreign officials to win business. The company paid \$800 million to settle investigations by the Justice Department and the Securities and Exchange Commission.

Even when the internal investigation is largely complete, that does not necessarily mean the legal fees have ended. They may only be shifted to a new arena if individuals from the company are charged. Virtually every publicly traded corporation has an indemnification provision in its corporate articles requiring it pay the lawyers for its officers and directors who may be accused of a violation, and in most cases those costs must be advanced during the course of an investigation or prosecution.

A report issued by the inspector general of the Federal Housing Finance Agency highlights just how high the legal fees can go. Fannie Mae, which is now controlled by taxpayers, has paid nearly \$100 million on behalf of three former officers accused of accounting violations by the S.E.C. in an investigation that began in 2004. Freddie Mac has paid \$10 million in legal fees for similar misconduct.

Those are not the only legal costs the companies and taxpayers will have to bear. The S.E.C. accused six former officers, including former chief executives Daniel H. Mudd of Fannie Mae and Richard F. Syron of Freddie Mac, of securities fraud, saying that they made misleading disclosures to shareholders about the companies' exposure to subprime mortgages. This type of civil case usually involves two to three years of discovery and preliminary motions, and the legal costs can easily exceed \$10 million per defendant long before there is a trial.

The indemnification provision at most companies requires an officer or director to commit to repaying any advances if the person is found liable for breaching a fiduciary duty or engaging in conduct designed to harm the corporation. That commitment is often not worth much once large legal fees have been dispensed because the person may not have the resources to repay the company. Although insurance can cover a portion of the legal fees, that still comes at a substantial cost to the company because insurance, like a lawyer, is not cheap.

A bill introduced by Representative Randy Neugebauer, Republican of Texas, that would limit the potential legal fees paid on behalf of individuals at Fannie Mae and Freddie Mac gives a hint at one way in which companies might be able to recover at least some of the legal costs paid to individuals accused of wrongdoing. The legislation, H.R. 2428, would direct the companies to insert into their by-laws a provision requiring any employee accused of "fraud, moral turpitude or breach of fiduciary duty" to "post collateral, security, bonding, or other assurances of repayment" in order to have the legal fees advanced. If the person were later held responsible to repay those costs, then there would be another avenue for the companies to recoup the payments.

Mr. Neugebauer's bill applies to only Fannie Mae and Freddie Mac. There would be strong opposition to a proposal to extend this requirement to publicly traded companies because it would be viewed as deterring individuals from serving as corporate officers and directors for fear of the potential costs. Companies could also try to get around the requirement by agreeing to pay any costs associated with a bond or collateral pledge.

Legal fees prompted by government investigations and prosecutions should be a matter of concern to investors because the amounts involved could grow quickly and become a drag on corporate profits. Cases can take years

to resolve, and companies have little control over legal fees they have contractually committed themselves to pay on behalf of individual employees. Yet, it is not clear whether companies will be interested in a mechanism like requiring a bond to allow recovery of a portion of advanced legal fees they may be owed if it means current officers and directors may face additional financial burdens.